

# NOTES

## REMOVAL WITHOUT CAUSE OF CORPORATE EXECUTIVES UNDER AGREEMENT

### INTRODUCTION

The attainment of some form of job security is a natural and basic goal in most trades and professions; this desire finds high-level expression in agreements purporting to bind a corporation or its shareholders to the retention of an officer for a fixed term.<sup>1</sup> When put to a judicial test, such agreements have frequently proven worthless. This Note will examine the subject of removal of executive officers and attempt to answer the following questions: if a corporation or its shareholders enter into an employment contract for a fixed term with one who thereby becomes an executive officer, what is, and what should be, the corporate or shareholder liability, if any, for the removal of such officer before the natural termination of the contract?

A number of introductory matters may be dealt with summarily. First, no liability is incurred for the removal of an officer for adequate cause,<sup>2</sup> and the courts, reluctant to question the broad discretion of the board of directors, will not interfere with the board's "removal for cause" unless it clearly appears that the action lacked honesty and fair judgment.<sup>3</sup> Second, the corporate officer must be distinguished from one who is an ordinary employee. Contracts of employment with "employees" are more likely to be enforced than are agreements binding a corporation to the fixed-

<sup>1</sup> The need for some assurance of tenure in a new position is most acute when the individual is offered a position by a corporation in a distant area. See, e.g., the facts of *United Producers & Consumers Co-op. v. Held*, 225 F.2d 615 (9th Cir. 1955). Job security acts as a protective cushion against the considerable sacrifices involved in relocation. Many of the same considerations are operative in instances which do not require transfer out of the state in which the individual resides; indeed, the contract might be with the corporation with which he has been associated for some time.

<sup>2</sup> *Fells v. Katz*, 256 N.Y. 67, 175 N.E. 516 (1931) ("An agreement to continue a man as president is dependent upon his continued loyalty to the interests of the corporation."). See also *McClayton v. W. B. Cassell Co.*, 66 F. Supp. 165 (D. Md. 1946); *Oliphant v. "Home Builders"*, 34 Cal. App. 720, 168 Pac. 700 (Dist. Ct. App. 1917); *Koppitz-Melchers, Inc. v. Koppitz*, 315 Mich. 582, 24 N.W.2d 220 (1946); *Smock v. Buchanan & Smock Lumber Co.*, 96 N.J. Eq. 308, 125 Atl. 115 (Ct. Err. & App. 1924); *Tremsky v. Green*, 106 N.Y.S.2d 572 (Sup. Ct. 1951); *Green Bay Fish Co. v. Jorgensen*, 165 Wis. 548, 163 N.W. 142 (1917). Often the tenure is conditioned upon the officer remaining faithful, efficient, and competent. See, e.g., *Hayden v. Beane*, 293 Mass. 347, 199 N.E. 755 (1936); *Clark v. Dodge*, 269 N.Y. 410, 199 N.E. 641 (1936). See also Meck, *Employment of Corporate Executives By Majority Stockholders*, 47 YALE L.J. 1079, 1092 n.32 (1938).

<sup>3</sup> *Koppitz-Melchers, Inc. v. Koppitz*, 315 Mich. 582, 24 N.W.2d 220 (1946); 2 FLETCHER, CYCLOPEDIA PRIVATE CORPORATIONS § 363, at 176 (rev. ed. 1954). The area of adequate cause is, of course, difficult to delineate, but the courts tend to be satisfied with conduct that does not rise to a level of seriousness which could be labelled "mismanagement." The court in *McClayton v. W. B. Cassell Co.*, *supra* note 2, at 170-71, remarked that "the position of a managerial officer of a corporation requires mental

term employment of "officers."<sup>4</sup> Whether or not a given position will be held to be that of an officer will depend primarily upon corporation statutes and corporate bylaws.<sup>5</sup> Third, removal must ordinarily be by the body authorized to have appointed or elected the officer<sup>6</sup>—that is, the directors or shareholders;<sup>7</sup> therefore, removal of an officer by a superior officer is ineffective.<sup>8</sup> Fourth, if removal is attempted in violation of the bylaws, the officer may not quit his office and also recover on the contract; rather,

and temperamental elements consistent with harmonious relations and mutual trust and confidence on the part of the several managers who must work together." For an example of what was held to be inadequate cause, see *Mansfield v. Lang*, 293 Mass. 386, 200 N.E. 110 (1936) (taking pay for overtime, charging rent for own garage, giving corporate funds to charity, and taking unauthorized six dollars per month expense money).

<sup>4</sup> See *Miller v. Vanderlip*, 285 N.Y. 116, 33 N.E.2d 51 (1941); *Munn v. Wellsburg Banking & Trust Co.*, 66 W. Va. 204, 66 S.E. 230 (1909) (bookkeeper held to be employee and not dischargeable without liability).

<sup>5</sup> Compare *United Producers & Consumers Co-op. v. Held*, 225 F.2d 615 (9th Cir. 1955) (general manager assumed to be an officer), with *Miller v. Vanderlip*, *supra* note 4 (general manager not an officer). Section 44 of the MODEL BUSINESS CORPORATION ACT (1953) provides: "The officers of a corporation shall consist of a president, one or more vice-presidents, as may be prescribed by the by-laws, a secretary, and a treasurer . . . ."

<sup>6</sup> See *Barber v. Wm. H. Horstman Co.*, 295 Pa. 253, 145 Atl. 133 (1929) (per curiam); 2 FLETCHER, CYCLOPEDIA PRIVATE CORPORATIONS § 357 (rev. ed. 1954).

<sup>7</sup> The majority of states provide for election by the board of directors. See ALASKA COMP. LAWS ANN. § 36-2A-52 (Supp. 1958); ARK. STAT. ANN. § 64-405 (1957); CAL. CORP. CODE § 821; Colo. Laws 1958, ch. 32, § 46(a); D. C. CODE ANN. § 29-919(a) (Supp. 1960); FLA. STAT. ANN. § 608.40 (1956); IDAHO CODE ANN. § 30-141(1) (1948); ILL. ANN. STAT. ch. 32, § 157.43 (Smith-Hurd 1954); IND. ANN. STAT. § 25-209 (1948); IOWA CODE ANN. § 496A.45 (Supp. 1959); KAN. GEN. STAT. ANN. § 17-3106 (1949); KY. REV. STAT. § 271.355(1) (1959); LA. REV. STAT. § 12:35(A) (1950); MICH. COMP. LAWS § 450.15 (1948); MINN. STAT. ANN. § 301.30(1) (1947); MO. ANN. STAT. § 351.360 (1952); NEV. REV. STAT. § 78.130 (1957); N.Y. STOCK CORP. LAWS § 60; N.D. REV. CODE § 10-1949 (Supp. 1957); OHIO REV. CODE ANN. § 1701.64(A) (Page Supp. 1959); ORE. REV. STAT. § 57.236 (1959); S.C. CODE § 12-54 (1952); S.D. CODE § 11.0707 (1939); TENN. CODE ANN. § 48-407 (1955); VT. STAT. ANN. tit. 11, § 224 (1958); VA. CODE ANN. § 13.1-45 (Supp. 1956); WASH. REV. CODE § 23.36.060 (1951); W. VA. CODE ANN. § 3030 (1955); WIS. STAT. § 180.41(1) (1957). The statutes of three other states also provide that directors shall elect the officers, but provide further that this method may be replaced by articles or bylaws directing otherwise. MD. ANN. CODE art. 23, § 60 (1957); N.C. GEN. STAT. § 55-34(a) (1960); PA. STAT. ANN. tit. 15, § 2852-406 (1958). North Carolina and Pennsylvania have appropriately made provision in their sections dealing with removal that only such officers as are elected by the directors may be removed by the directors. N.C. GEN. STAT. § 55-34(d) (1960); PA. STAT. ANN. tit. 15, § 2857-407 (1958). The Maryland statute allows election by the stockholders, where the bylaws so provide, and yet states elsewhere that the board of directors may remove a corporate officer. MD. ANN. CODE art. 23, § 61 (1957). No case has arisen testing this apparent power of the directors to remove officers appointed by the stockholders, but it is submitted that the directors would be held powerless to do so, despite the legislative terms. Consider the ridiculousness of election by the shareholders, removal by the directors, reelection by the shareholders, removal by the directors—ad infinitum, at least until the directors themselves were removed. Most other states permit election by either directors or shareholders, as the prescribed corporate documents may direct. *E.g.*, DEL. CODE ANN. tit. 8, § 142(a) (1953); NEB. REV. STAT. § 21-116 (1954); N.M. STAT. ANN. § 51-2-15 (1953).

<sup>8</sup> *Nahikian v. Mattingly*, 265 Mich. 128 (1933) (attempted removal by minority shareholders); *Morris v. Blume*, 55 N.Y.S.2d 196 (Sup. Ct.), *aff'd*, 269 App. Div. 832, 56 N.Y.S.2d 414 (1945) (attempted removal by corporate president). Under no statute does an officer have authority to elect or appoint other officers. Where an officer, without implied or apparent authority to enter into an employment contract, enters into such contract and the proper body fails to ratify it, the contract is unenforceable. *McLaughlin v. Ford Motor Co.*, 269 F.2d 120 (6th Cir. 1959).

he must tender his continued services to the body which appointed or elected him.<sup>9</sup> And finally, the hiring party in the officer's employment agreement may be either the corporation itself or the shareholders;<sup>10</sup> inasmuch as understandings with stockholders involve considerations somewhat different from those relevant to corporation agreements,<sup>11</sup> it will be helpful to examine the two types separately.

## AGREEMENTS WITH THE CORPORATION

### *Damages*

#### The Early Cases

Some of the first cases to test the validity of executive employment agreements with corporations<sup>12</sup> arose in the states of Washington and West Virginia, each of which had statutes expressly providing that corporate officers could be removed by the directors at their pleasure.<sup>13</sup> The courts in these early cases invalidated employment contracts by mechanistically applying the rationale that a corporation, being by charter a creature of the

<sup>9</sup> Birmingham Realty Co. v. Hale, 16 Ala. App. 460 (1918); Ginter v. Heco Envelope Co., 316 Ill. 183, 147 N.E. 42 (1925); Keil v. Fred Medart Mfg. Co., 46 S.W.2d 934 (Mo. Ct. App. 1932).

<sup>10</sup> Often these agreements are reached as a part of a contract for the purchase or sale of shares. See, e.g., Hayden v. Beane, 293 Mass. 347, 199 N.E. 755 (1936) (purchase); Manson v. Curtis, 223 N.Y. 313, 119 N.E. 559 (1918) (sale).

<sup>11</sup> See Leech, *Transactions in Corporate Control*, 104 U. PA. L. REV. 725, 787-88 n.181 (1956), where it is suggested that contracts with the corporation may be treated differently by the courts than contracts with *majority shareholders*. One reason why this is undoubtedly true is that agreements with shareholders are normally found in instances involving closely held corporations, see text at note 77 *infra*, and there is a tendency today to treat closely held corporations differently from publicly held corporations. See Katcher v. Ohsman, 26 N.J. Super. 28, 97 A.2d 180 (Super. Ct. 1953); Chayes, *Madame Wagner and the Close Corporation*, 73 HARV. L. REV. 1532-35, 1549 (1960). And see the discussion of the New York development in *In the Matter of Burkin*, 286 App. Div. 740, 147 N.Y.S.2d 2 (1955), *rev'd*, 1 N.Y.2d 570, 136 N.E.2d 862, 154 N.Y.S.2d 898 (1958). Also, in the cases involving contracts with a majority of the shareholders, a second reason for nonenforcement becomes available: the protection of the interests of noncontracting shareholders and, perhaps, of others. See text accompanying notes 81-88 *infra*.

<sup>12</sup> The fixed-term contract is the usual type. They have ranged in duration from one year, e.g., Cuppy v. Stollwerck Bros., 216 N.Y. 591 (1916), to twenty years, e.g., *In re Petrol Terminal Corp.*, 120 F. Supp. 867 (D. Md. 1954). Naturally, to be enforceable, such a contract must be properly executed. McLaughlin v. Ford Motor Co., 269 F.2d 120 (6th Cir. 1959). This requirement is fulfilled if the contract is signed by the board of directors, Realty Acceptance Corp. v. Montgomery, 51 F.2d 636 (3d Cir. 1930), by a duly authorized officer, Nikas v. Hindley, 99 Ga. App. 194, 108 S.E.2d 98 (1959), or by an officer whose act is subsequently approved by a resolution of the directors, Nelson v. Pioneer Specialties, Inc., 325 S.W.2d 924 (Tex. Civ. App. 1959), *rev'd on other grounds*, 1960 CCH CORP. L. GUIDE ¶ 9890 (Tex. Oct. 5, 1960). It has been held that acquiescence by the directors over a period of months will breathe life into an employment contract made by an officer in excess of his express authority. Oliver v. Autographic Register Co., 118 N.J. Eq. 72, 177 Atl. 680 (Ch. 1935), *aff'd per curiam*, 119 N.J. Eq. 481, 183 Atl. 171 (Ct. Err. & App. 1936) (several years); Fanney v. Virginia Inv. & Mortgage Co., 200 Va. 642, 107 S.E.2d 414 (1959) (sixteen months).

<sup>13</sup> Wash. Laws 1873, § 4(5), at 399 (deleted by WASH. REV. CODE § 23.36.060(4) (1951)); W. Va. Acts 1882, ch. 96, § 53 (deleted by W. VA. CODE ANN. § 3030 (1955)).

state, must conform to the rules of its creator. Illustrative is *Llewellyn v. Aberdeen Brewing Co.*:<sup>14</sup> plaintiff, under a three-year contract with the board of directors as assistant manager of defendant corporation, sued for breach when removed without cause after fourteen months' employment. The Washington Supreme Court, affirming the lower court's nonsuit, cited the state statute and declared that if the directors of a corporation could enter into a three-year contract, a later board would be deprived of the statutory removal power. The court also stressed the plaintiff's knowledge that the statute allowed removal at will and that the provision would be considered a part of the agreement.<sup>15</sup> Four years later, the same court<sup>16</sup> was faced with a case<sup>17</sup> virtually identical except that, in addition to having the directors' indorsement, the agreement had been approved by unanimous vote of the stockholders. In view of the rationale expressed in *Llewellyn*, this additional fact obviously could make no difference, and the defendant corporation's successful demurrer in the lower court to an action for damages was affirmed with the statement that "'such officer is bound to know that he is removable at the pleasure of the board, and that a contract for a definite period is executed without authority.'" <sup>18</sup>

While Washington and West Virginia denied relief to dismissed executives by relying upon legislation vesting in boards of directors the power of removal at pleasure, the Texas courts reached the same result without such a provision. In 1939 the Texas Court of Appeals affirmed a judgment for the corporate defendant in an action for breach of contract brought by the corporation's former president; the plaintiff had been engaged for a term of two years and was removed without cause after five months.<sup>19</sup> The court, observing that the Texas statute provided for management of the corporate business by the directors<sup>20</sup> and for annual elec-

<sup>14</sup> 65 Wash. 319, 118 Pac. 30 (1911).

<sup>15</sup> *Id.* at 321-22, 118 Pac. at 31.

<sup>16</sup> Although a different department.

<sup>17</sup> *Murray v. MacDougall & Southwick Co.*, 88 Wash. 358, 153 Pac. 317 (1915).

<sup>18</sup> *Id.* at 360, 153 Pac. at 318. *Accord*, *Long v. United States Sav. & Annuity Co.*, 76 W. Va. 31, 84 S.E. 1053 (1915); *Darrah v. Wheeling Ice & Storage Co.*, 50 W. Va. 417, 40 S.E. 373 (1901).

<sup>19</sup> *Edwards v. Keller*, 133 S.W.2d 823 (Tex. Civ. App. 1939). The court assumed, though there was no evidence, that the directors had expressly authorized the conduct.

<sup>20</sup> TEX. REV. CIV. STAT. art. 1327 (Supp. 1960). In light of the general tendency to allow damages for breach of corporate employment contracts today, it is noteworthy that forty jurisdictions presently have such a statutory provision: ALA. CODE tit. 10, § 21(24) (Supp. 1959); ALASKA COMP. LAWS ANN. § 36-2A-41 (Supp. 1958); ARK. STAT. ANN. § 64-401 (1957); CAL. CORP. CODE § 800; COLO. LAWS 1958, ch. 32, § 34, at 140; DEL. CODE ANN. tit. 8, § 141(a) (1953); D.C. CODE ANN. § 29-916 (Supp. VIII, 1960); FLA. STAT. ANN. § 608.09(1) (1956); ILL. ANN. STAT. ch. 32, § 157.33 (Smith-Hurd Supp. 1959); IOWA CODE ANN. § 496A.34 (Supp. 1959); KY. REV. STAT. § 271.345(1) (Supp. 1958); LA. REV. STAT. § 12:34A (1950); MD. CODE ANN. art. 23, § 52(a) (1957); MASS. GEN. LAWS ch. 156, § 21 (1932); MICH. COMP. LAWS § 450.13(1) (1948); MINN. STAT. ANN. § 301.28 (1947); MO. ANN. STAT. § 351.310 (1952); NEB. REV. STAT. § 21-111 (1954); NEV. REV. STAT. § 78.115 (1957); N.H. REV. STAT. ANN. § 294:89 (1955); N.J. REV. STAT. § 14:7-1 (1937); N.M. STAT. ANN. § 51-2-14 (1953); N.Y. GEN. CORP. LAWS § 27; N.C. GEN. STAT. § 55-24(a) (1960); N.D. REV. CODE § 10-1936 (Supp. 1957); OHIO REV. CODE ANN. § 1701.59 (Page Supp. 1959); OKLA. STAT. ANN. tit. 18, § 1.34 (1953); ORE.

tions of directors,<sup>21</sup> held that where the terms of a contract extend beyond the tenure of the directors, thereby taking from the incoming directors "the power of directing the corporate affairs, . . . such contracts are void."<sup>22</sup> And this was true regardless of whether it might be shown that over the period in question the same members were repeatedly elected and reelected as directors: "the validity of . . . [the directors'] action is to be determined by legal rules, and not by particular conditions that may exist."<sup>23</sup>

In states having statutes lacking a specific grant to the directors of the power of removal or the power to manage the corporate affairs, similar provisions in the bylaws or charter were relied upon in invalidating agreements with officers for fixed terms. Thus, in *Fowler v. Great So. Tel. & Tel. Co.*,<sup>24</sup> the Louisiana Supreme Court denied recovery of damages for breach of an employment contract. The court observed that: "[T]he measure of power vested in the board of directors is determined by the charter and by-laws, and the board's action in excess thereof is not binding upon the corporation . . . . It was in the power of the board to remove him from office at any time, and when they exercised that power all he could claim in the way of salary was what was due him up to the date of the acceptance of his resignation."<sup>25</sup>

### Legislative and Judicial Change

The *Fowler*-type result, resting upon an oblique conflict of directors' action with a corporation's own rules, is open to serious question, and this is particularly so where the bylaws or charter further provides that the power to alter and amend the bylaws is vested in the directors. In that event the contract itself, having been executed by the directors, may be viewed as necessarily amending the bylaw which provided for removal at any time. Such an amendment theory has been recognized by the Louisiana Supreme Court<sup>26</sup> and by a federal court,<sup>27</sup> both of which awarded contract

REV. STAT. § 57.180 (1959); PA. STAT. ANN. tit. 15, § 2852-401 (1958); R.I. GEN. LAWS ANN. § 7-4-6 (1956); S.D. CODE § 11.0705 (1939); TENN. CODE ANN. § 48-401 (1955); TEX. BUS. CORP. ACT art. 2.31A (1956); UTAH CODE ANN. § 16-2-21 (1953); VT. STAT. ANN. tit. 26, ch. 258, § 5779 (1947); VA. CODE ANN. § 13.1-35 (1956); WASH. REV. CODE § 23.36.010 (Supp. 1955); W. VA. CODE ANN. § 3028 (1955); WIS. STAT. § 180.30 (1957); WYO. COMP. STAT. ANN. § 17-12 (Supp. 1959).

<sup>21</sup> TEX. BUS. CORP. ACT art. 2.32 (1956).

<sup>22</sup> 133 S.W.2d at 825. *Accord*, *Beaton v. Continental Southland Sav. & Loan Ass'n*, 101 S.W.2d 905 (Tex. Civ. App. 1937).

<sup>23</sup> *Denton Milling Co. v. Blewett*, 254 S.W. 236, 238-39 (Tex. Civ. App.), *appeal dismissed*, 114 Tex. 582, 278 S.W. 114 (1923) (per curiam).

<sup>24</sup> 104 La. 751, 29 So. 271 (1901). *Accord*, *Cohen v. Camden Refrigerating & Terminals Co.*, 129 N.J.L. 519, 30 A.2d 428 (Ct. Err. & App. 1943).

<sup>25</sup> 104 La. at 752, 29 So. at 272-73.

<sup>26</sup> *Hill v. American Co-op. Ass'n*, 195 La. 590, 197 So. 241 (1940).

<sup>27</sup> In *Realty Acceptance Corp. v. Montgomery*, 51 F.2d 636 (3d Cir. 1930), despite a bylaw providing for removal at will, plaintiff, removed during his term of five years as president, was granted contract damages. The court observed: "To read into a contract of employment for a definite period, expressly authorized by the board of directors, a by-law amendable by a majority of the board, and thus nullify the contract, would sacrifice substance and straightforwardness for form and procedure. Defend-

damages for removal without cause before the natural termination of the officer's contract despite a bylaw allowing removal at will. But even where the directors do not have power to amend the bylaws, there is much to be said for recovery. The absence of conflict with legislative mandates distinguishes the Texas, Washington, and West Virginia cases which so strictly dogmatized that a contract departing from the express or implied rules of the state was ipso facto void and unenforceable. Once free from this line of cases, should the courts deny a corporate executive recovery on a seemingly valid contract entered into in good faith merely because this agreement is an *indirect* infraction—not by him but by the board of directors—of the corporation's rule? In such circumstances, it seems appropriate that the corporation be estopped from raising as a defense to an otherwise valid contract claim the fact of violation (if it be a violation) by those representing it. And it is arguable that in the allowance of such damage claims lies an ultimate *corporate* advantage, for the ability to secure more competent personnel to serve as executives would be complemented by assurance that the contract will not be meaningless.

In recent years there has been a gradual swing toward the view that the remedy of damages should be available to the executive having an employment agreement with a corporation which has ousted him without cause. This shift has resulted in large measure from the widespread adoption<sup>28</sup> of legislation similar to section 45 of the Model Business Corporation Act,<sup>29</sup> which provides: "Any officer or agent may be removed by

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ant's further contention that, if the contract be upheld at the expense of the by-law, boards of directors may by contract of employment for terms of years perpetuate their business policy and deprive succeeding boards of the power to afford relief, is not convincing. It sticks in the bark, for the evil possibilities suggested have their true foundation, not in the supremacy of contract over by-law, but in the futility of a limitation which rests solely upon a by-law amendable by a majority of the board. Were there doubt of the board's power to amend by necessary implication through solemnly authorized, inconsistent acts, the limitation would constitute no barrier to the commission of the suggested acts by a board so disposed, for the board could formally and expressly repeal the by-law containing the limitation and thereupon with all regularity authorize the contracts for terms of years." *Id.* at 639.

<sup>28</sup> ALASKA COMP. LAWS ANN. § 36-2A-53 (Supp. 1958); Colo. Laws 1958, ch. 32, § 47; CONN. GEN. STAT. REV. § 33-319(b) (Supp. 1959); D.C. CODE ANN. § 29-919a (Supp. VIII, 1960); ILL. ANN. STAT. ch. 32, § 157.44 (Smith-Hurd Supp. 1959); IOWA CODE ANN. § 496A.46 (Supp. 1959); KY. REV. STAT. § 271.355(4) (Supp. 1959); LA. REV. STAT. § 12:35D (1950); MD. ANN. CODE art. 23, § 61 (1957); MICH. COMP. LAWS § 450.15 (1948); MINN. STAT. ANN. § 301.30(3) (1947); MO. ANN. STAT. § 351.36 (1952); N.C. GEN. STAT. § 55-34(d) (1960); N.D. REV. CODE § 10-1950 (Supp. 1957); OHIO REV. CODE ANN. § 1701.64(B)(2) (Page Supp. 1959); OKLA. STAT. ANN. tit. 18, § 1.44 (1953); ORE. REV. STAT. § 57.241 (1959); PA. STAT. ANN. tit. 15, § 2852-407 (1958); TEX. BUS. CORP. ACT art. 2.43A (1956); VA. CODE ANN. § 13.1-46 (1956); WASH. REV. CODE § 23.36.060(4) (Supp. 1955); WIS. STAT. ANN. § 180.42 (1957). In New York and Vermont the corporate statutes provide merely that officers may be removed at the pleasure of the board of directors. N.Y. STOCK CORP. LAWS § 60; VT. STAT. ANN. tit. 11, § 224 (1958). See note 37 *infra*. The only other state statutes having provisions regarding removal are UTAH CODE ANN. § 16-2-27 (1953), and W. VA. CODE ANN. § 3032 (1955), both expressly leaving the matter to be determined by the bylaws; and DEL. CODE ANN. tit. 8, § 142(e) (1953), and NEB. REV. STAT. § 21-118 (1954), which provide for the filling of vacancies occurring as a result of removal but are otherwise silent on the subject.

<sup>29</sup> MODEL BUSINESS CORPORATION ACT § 45 (1953).

the board of directors, or by the executive committee, if any, whenever in its judgment the best interests of the corporation will be served thereby, but such removal shall be without prejudice to the contract rights, if any, of the person so removed. Election or appointment of an officer or agent shall not of itself create contract rights."<sup>30</sup> On the basis of this new statute, the Supreme Court of Washington<sup>31</sup> distinguished earlier cases and held that the directors' use of the statutory power to remove corporate officers does not disturb the ex-officer's contract rights. Similarly, in 1960 Texas indicated that it would allow recovery of damages for breach of a contract whereby plaintiff was employed for two years as president of defendant corporation and removed without cause after only four months, provided that the contract be not prohibited by the charter or bylaws.<sup>32</sup> It was conceded that, in view of the 1951 amendment to the corporate law,<sup>33</sup> state policy no longer prohibited corporations through their directors from entering into contracts of employment for such periods of time as they might wish.

With the advent of these later cases<sup>34</sup> and statutory changes,<sup>35</sup> Washington, West Virginia, Texas, and Louisiana have adopted what has come to be the majority view:<sup>36</sup> that, regardless of statutory provisions sanctioning at-pleasure removal<sup>37</sup> and with the exception of those cases involving express prohibitions in charters or bylaws,<sup>38</sup> a corporate executive employment agreement for a fixed term will give rise to an action for contract damages in the event of removal without cause prior to the expiration of the term.<sup>39</sup> Certainly, such a rule is reasonable: in these times of rapid expansion of industry and equally rapid contraction of national boundaries through improved transportation, corporations are more likely to look out-

<sup>30</sup> This last sentence was added in 1953 and has thus far been included in the statutes of Alaska, Colorado, Connecticut, Illinois, Iowa, North Dakota, Ohio, Texas, Virginia, and Wisconsin.

<sup>31</sup> *Hansen v. Columbia Breweries, Inc.*, 12 Wash. 2d 554, 122 P.2d 489 (1942).

<sup>32</sup> See *Pioneer Specialties, Inc. v. Nelson*, 1960 CCH CORP. L. GUIDE ¶ 9890 (Tex. Oct. 5, 1960). The court held, however, that a bylaw prohibited the directors from entering into contracts for periods longer than one year. Compare the lower court opinion, 325 S.W.2d 924 (Tex. Civ. App. 1959).

<sup>33</sup> TEX. REV. CIV. STAT. art. 1327 (Supp. 1960).

<sup>34</sup> The earlier cases have recently been referred to as "stale authorities" in *United Producers & Consumers Co-op. v. Held*, 225 F.2d 615, 617 (9th Cir. 1955).

<sup>35</sup> See discussion of current statutes at notes 28-30 *supra* and accompanying text.

<sup>36</sup> *United Producers & Consumers Co-op. v. Held*, 225 F.2d 615 (9th Cir. 1955); *Realty Acceptance Corp. v. Montgomery*, 51 F.2d 636 (3d Cir. 1930); *In re Paramount Publix Corp.*, 15 F. Supp. 465 (S.D.N.Y. 1936), *aff'd*, 90 F.2d 441 (2d Cir. 1937); *Nikas v. Hindley*, 99 Ga. App. 194, 108 S.E.2d 98 (1959).

<sup>37</sup> This majority includes the New York case of *Cuppy v. Stollwerck Bros.*, 216 N.Y. 591, 111 N.E. 249 (1916). The New York statute then provided and still provides that officers may be removed "at pleasure" of the directors. N.Y. STOCK CORP. LAWS § 60. See *In re Paramount Publix Corp.*, *supra* note 36, at 466.

<sup>38</sup> See, e.g., TEX. REV. CIV. STAT. art. 1327 (Supp. 1960); *Pioneer Specialties, Inc. v. Nelson*, 1960 CCH CORP. L. GUIDE ¶ 9890 (Tex. Oct. 5, 1960); *Nikas v. Hindley*, 99 Ga. App. 194, 199-200, 108 S.E.2d 98, 102 (1959). Where directors have the power to amend the bylaws, the contract should be upheld despite a prohibitive bylaw. See text preceding note 26 *supra*.

<sup>39</sup> *Accord*, England. See, e.g., *Nelson v. Nelson & Sons*, [1913] 2 K.B. 471.

side their immediate geographical area in search of high-level executive manpower, and the individual is more likely to consider relocation. When a corporation finds *the* man for an executive position, it will wish to offer the most attractive position possible. On his part, the individual will desire an assurance of security prior to relocation. The result is negotiation culminating in a contract presuming to guarantee some degree of tenure. This is, in reality, a positive exercise by the directors of their power to manage the corporation<sup>40</sup>—the power inviolate which the early courts sought to protect by invalidating such contracts. The worst that can be said of fixed-term contracts is that they give rise to the possibility of corporate liability in the event that succeeding boards would prefer to abolish the position or to hire someone else to fill it.<sup>41</sup> But to uphold in an action for damages the validity of an agreement made for a reasonable length of time results at most in a loss of a few times the annual salary. The directors take this same risk when they enter into a long-term lease.<sup>42</sup> These corporate considerations—in addition to the inequity and actual injury inherent in removal without relief that fall upon the officer at the opposite end of the bargain—afford ample reason for allowing executive employment agreements to support an action for damages. And in most instances this is the law today.

### Reasonableness

However, judicial opinion indicates that this modern rule is not to be automatically applied whenever a case involving a fixed-term executive employment contract arises. The court in *Realty Acceptance Corp. v. Montgomery*,<sup>43</sup> granting damages for breach of contract, stated:

Nor was the contract one against public policy . . . the restraint thereby placed upon the future freedom . . . of defendant's board of directors cannot be said to have been in fact or principle injurious to the public interest. The term of office therein fixed was neither permanent, unlimited nor for life, but, in view of plaintiff's relation to defendant and his familiarity and grasp of its business, was for a reasonable period only.<sup>44</sup>

The court did *not* say that *no* contract for a fixed term is against public policy or injurious to the public interest; it merely stated that *this* contract

<sup>40</sup> See note 20 *supra*.

<sup>41</sup> The likelihood of the present board removing the officer without cause is somewhat remote, if good faith in the negotiations is posited.

<sup>42</sup> This point was made in *Hansen v. Columbia Breweries, Inc.*, 12 Wash. 2d 554, 560, 122 P.2d 489, 491-92 (1942). Observing that natural persons can make long-term contracts, the court found further support in a provision of the corporate law stating that corporations have the "capacity to act possessed by natural persons." *Id.* at 559, 122 P.2d at 491. See also *In re Paramount Publix Corp.*, 90 F.2d 441, 445 (2d Cir. 1937).

<sup>43</sup> 51 F.2d 636 (3d Cir. 1930).

<sup>44</sup> *Id.* at 639. The opinion does not elaborate on what plaintiff's "relation" to the defendant was, other than that of a "past" president.



was not in that class and proceeded to give the reasons therefor. Similarly, in 1955 the Ninth Circuit upheld a lower court judgment awarding damages to plaintiff for breach of a contract under which defendant corporation had employed plaintiff for a period of three years as general manager.<sup>45</sup> The court observed that "the members of the boards of the appellant corporations were elected for staggered three year terms. The contract made with appellee was for a period of three years." Under these facts the court found "no sound reason to repudiate the conclusion that the contract in the case at bar was made for a *reasonable time* and is *therefore valid*."<sup>46</sup> Thus there is a limit of reasonableness superimposed on the majority rule. And what is an unreasonably lengthy contract will depend upon myriad circumstances, including the experience of the officer,<sup>47</sup> the term of office,<sup>48</sup> the length of the fixed period,<sup>49</sup> the term for which directors are elected,<sup>50</sup> the salary (in that it will determine the extent of damages in the event of removal by the directors),<sup>51</sup> the position,<sup>52</sup> and the nature of the corporation (in that a corporation with high net profits could more easily withstand large contract damages). The cases discussed above are representative of contracts within the allowable sphere but contracts falling beyond the line of enforceability can easily be envisioned: for instance, an agreement attempting to bind the corporation for the life of the officer, or a contract for one year with a twelve-year-old boy for the position of secretary.<sup>53</sup>

### *Specific Enforcement*

The fixed-term executive employment contract of reasonable length is today quite capable of supporting a damage action for its breach; however, the courts are not persuaded that specific enforcement of such contracts is a proper remedy.<sup>54</sup> But while reluctance to grant specific performance

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<sup>45</sup> *United Producers & Consumers Co-op. v. Held*, 225 F.2d 615 (9th Cir. 1955). The defendant corporation had a bylaw providing that the manager "shall hold office at the pleasure of and upon terms and conditions fixed by the Board of Directors." *Id.* at 617.

<sup>46</sup> *Id.* at 620. (Emphasis added.)

<sup>47</sup> See text at note 44 *supra*.

<sup>48</sup> *Ibid.*

<sup>49</sup> *Ibid.* Such contracts for periods as long as five years were held enforceable in actions for breach in *Realty Acceptance Corp. v. Montgomery*, 51 F.2d 636 (3d Cir. 1930); *Nikas v. Hindley*, 99 Ga. App. 194, 108 S.E.2d 98 (1959). See also discussion of the *Staklinski* case (a 1959 decision which enforced an arbitration award of specific performance of a contract for eleven years) at notes 58-72 *infra*.

<sup>50</sup> *Ibid.*

<sup>51</sup> But note that a discharged officer is under an obligation to mitigate damages by making reasonable efforts to gain employment elsewhere. See *Hansen v. Columbia Breweries, Inc.*, 12 Wash. 2d 554, 562-63, 122 P.2d 489, 492-93 (1942) (dictum).

<sup>52</sup> Obviously, a secretary is less likely to interfere with the board's vested power of management than is the president, and thus is correspondingly less likely to provoke attempts at removal.

<sup>53</sup> See Meck, *Employment of Corporate Executives by Majority Stockholders*, 47 YALE L.J. 1079, 1094 & n.34 (1938).

<sup>54</sup> See *Frank v. Anthony*, 107 So. 2d 136, 138-39 (Fla. Dist. Ct. App. 1958): "If [the removed president's] . . . contract of employment as president was breached by

exists—indeed, at least one state statute forbids it,<sup>55</sup> arbitrators upon occasion have decreed specific performance of employment contracts brought before them.<sup>56</sup> In the past, these awards were granted and upheld by the courts in instances involving an “employee” rather than an “officer.”<sup>57</sup> The first instance in which an arbitration order of specific performance<sup>58</sup> of an *officer's* employment contract with a corporation was judicially enforced was the recent New York case, *In the Matter of Staklinski*.<sup>59</sup> There, petitioner Staklinski, under a written contract of employment for eleven years as manager of defendant corporation at a salary of \$40,000

his removal, he has an appropriate remedy by an action for damages thereon.” Williston gives two other reasons for denial of specific performance: “(1) Long and minute supervision might be needed to secure the proper execution of the decree; (2) the proper performance of the services to the best of the defendant’s ability is uncertain and difficult to gauge.” Williston adds that “any attempt to overcome these difficulties might involve too serious an infringement of personal liberty to be tolerable.” WILLISTON, *CONTRACTS* § 1423A, at 3983 (rev. ed. 1937). See also 1 HORNSTEIN, *CORPORATION LAW AND PRACTICE* § 519, at 651 (1959); *RESTATEMENT, CONTRACTS* § 379 (1932). However, a writ of mandamus will issue to compel reinstatement where the removal is clearly in violation of the bylaws, charter, or statute—*e.g.*, where less than the required number of directors voted for removal; but even then the writ will issue only if necessary to prevent “injustice or great injury.” *State ex rel. Blackwood v. Brast*, 98 W. Va. 596, 127 S.E. 507 (1925) (dictum). See also *Morris v. Blume*, 55 N.Y.S.2d 196 (Sup. Ct.), *aff’d*, 269 App. Div. 832, 56 N.Y.S.2d 414 (1945), which held that plaintiff, under contract of employment for a stated salary “until the board of directors otherwise direct,” could enjoin the corporation president from interfering with the performance of his duties and withholding his salary. See generally note 8 *supra*. But see *In the Matter of Allied Fruit & Extract Co.*, 243 App. Div. 52, 276 N.Y. Supp. 153 (1934), which suggests that in membership corporations mandamus is the proper proceeding to determine right to reinstatement. Ordinarily mandamus will not lie to try title to a disputed corporate office. *FLETCHER, CYCLOPEDIA PRIVATE CORPORATIONS* § 366, at 184 (rev. ed. 1954). In such a case the removed officer may seek quo warranto proceedings. *Tonkin v. Kenworthy*, 112 N.J.L. 274, 170 Atl. 233 (Sup. Ct. 1934); *State ex rel. Walker v. Maas*, 4 N.J. Misc. 230, 132 Atl. 322 (Sup. Ct. 1926).

<sup>55</sup> *E.g.*, CAL. CIV. CODE § 3390.

<sup>56</sup> See, *e.g.*, *In the Matter of Ruppert*, 3 N.Y.2d 576, 148 N.E.2d 129, 170 N.Y.S.2d 785 (1958).

<sup>57</sup> *E.g.*, *In the Matter of Ruppert*, *supra* note 56; *In the Matter of Devery*, 292 N.Y. 596, 55 N.E.2d 370 (1944).

<sup>58</sup> Such a result, of course, gives rise to the possibility that a court may be called upon to enforce an award that would not have been granted had the case originated before the court. In New York it is provided that either party may enforce a contractual agreement to submit disputes to arbitration. N.Y. CIV. PRAC. ACT § 1450. Eighteen states now have statutes similar to that of New York. See 34 N.Y.U.L. REV. 961, 962 n.9 (1959). And New York limits defenses available to the defendant in resisting an action to confirm an award. N.Y. CIV. PRAC. ACT §§ 1461-62, 1462(a). However, it is significant to note that even the New York courts have on occasion departed from the strict legislative command and vacated, modified, or corrected awards on grounds of public policy. *E.g.*, *In the Matter of Publishers’ Ass’n*, 280 App. Div. 500, 114 N.Y.S.2d 401 (1952). See 34 N.Y.U.L. REV. 961, 963 (1959). Some state statutes provide that courts called upon to enforce arbitration awards shall retain equitable jurisdiction. ILL. ANN. STAT. ch. 10, § 13 (Smith-Hurd 1941); KY. REV. STAT. § 417.018 (Supp. 1959); MICH. COMP. LAWS § 645.12 (1948); MISS. CODE ANN. § 297 (1956); VA. CODE ANN. § 8-506 (1957); W. VA. CODE ANN. § 5502 (1955). Presumably this would allow them to determine the propriety of awards of specific performance. Courts have indicated that the same result would be reached in the absence of a statute. See, *e.g.*, *Goldstein v. International Ladies’ Garment Workers’ Union*, 328 Pa. 385, 394, 196 Atl. 43, 47-48 (1938); 34 N.Y.U.L. REV. 961, 962-63 (1959).

<sup>59</sup> 6 N.Y.2d 159, 160 N.E.2d 78, 188 N.Y.S.2d 541 (1959), *affirming* 6 App. Div. 2d 565, 180 N.Y.S.2d 20, *affirming* 10 Misc. 2d 706, 172 N.Y.S.2d 224 (Sup. Ct. 1958).

per year, was discharged after two years by the board of directors, who acted under a section of the contract providing that if Staklinski were unable for a period of three months to perform his duties in a substantial manner, the board would then meet to determine the nature of the disability. If permanent rather than temporary disability were found, the corporation was to be excused from contract liability.<sup>60</sup> The contract further stated that "any controversy or claim arising out of or relating to this agreement, or the breach thereof, shall be settled by arbitration in accordance with the rules then obtaining of the American Arbitration Association."<sup>61</sup> Pursuant to the latter provision, petitioner sought arbitration. A majority of the arbitrators upheld his contention that he was not permanently disabled and that the action of the board of directors was an abuse of their discretion. Staklinski was ordered reinstated, and the company appealed.

In dismissing the appeal, the supreme court held that the arbitrators' award was binding and that "the fact that our courts, were petitioner the plaintiff in an action, would not grant specific performance does not necessarily deprive arbitrators of the right to grant such relief, especially where the parties have expressly agreed that they might do so."<sup>62</sup> As to respondent's contention that specific performance was against public policy, the court said:

It is true that it does not seem desirable that a company, especially a publicly owned corporation, should be compelled, instead of paying damages, to restore a person to an important managerial position for the balance of a long term contract, despite the judgment of its Board of Directors that he is permanently disabled. The reasoning of . . . [Ruppert] appears, however, to require this undesirable result . . .<sup>63</sup>

The appellate division, affirming three-to-two, had this to say:

This cannot be termed such interference with the corporate management by its Board of Directors as to constitute a violation of the statutes applicable. Cases are legion upholding the right and power of a corporation by its Board of Directors or other proper person to enter or authorize contracts of employment for extended terms. If entered in good faith, in accordance with existing law, the charter and by-laws of the corporation, such contracts are valid . . . Just as the applicable statutes defining the powers and duties of directors of corporations . . . are not limitations on the corporate powers to

<sup>60</sup> 10 Misc. 2d at 707-08, 172 N.Y.S.2d at 226.

<sup>61</sup> *Ibid.* One of the rules then obtaining was that the arbitrator "may grant any remedy or relief which he deems just and equitable . . . including . . . specific performance of a contract." *Id.* at 708, 172 N.Y.S.2d at 227.

<sup>62</sup> 10 Misc. 2d at 709, 172 N.Y.S.2d at 227.

<sup>63</sup> 10 Misc. 2d at 711, 172 N.Y.S.2d at 228-29. But the cases cited all dealt with "employee" as opposed to "officer" contracts. See notes 4 and 5 *supra* and accompanying text.

make binding contracts of employment for extended terms, so the provisions for arbitration of disputes relating to such employment and the awards that may result do not offend the statutory purport. Nor does the provision for arbitration or any award made thereunder deprive the corporate board of its power to discharge its duties with respect to the corporate affairs, albeit like any contract it thereafter narrows the choices open to the corporation.

It must be remembered that the statute [vesting management of corporate business in the board of directors]<sup>64</sup> does not establish an absolute or universal norm from which there can be no variation . . . .

It becomes apparent then that the distinction here, if any, must be because of the job level, for, as pointed out, employment contracts as such, and awards thereunder directing reinstatement, have been upheld.<sup>65</sup>

And the court of appeals also affirmed, emphasizing in its brief opinion that the corporation made a valid contract in which it agreed to arbitrate disputes. "Since the contract was indisputably valid, so is the arbitration award."<sup>66</sup>

Does *Staklinski* extend too far the rights of corporate officers under an employment contract? The extension can not be appropriately attacked on the equity grounds that the officer has an adequate remedy at law, for the contracting parties have agreed to an arbitration which by its terms expresses a desire for more than the usual relief. And the corporation's acquiescence in the availability of specific performance considerably weakens the argument that the award violates public policy. To be sure, there are undesirable effects inherent in compelling a business to accept the services of a high-ranking executive whom the directors consider a corporate liability, but the possibility of judicial effectuation of this result is traceable to the complaining company. Specific enforcement in this instance is not a remedy so foreign and harsh as to be judicially intolerable despite agreement by all parties as to its availability.<sup>67</sup>

Granting the reasonableness of the case when attention is focused on the above inquiries, *Staklinski* raises a further consideration which the New York courts facilely glossed over: the reconciliation of the result with section 60 of the Stock Corporation Act, which provides, *inter alia*, that

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<sup>64</sup> N.Y. GEN. CORP. LAWS § 27.

<sup>65</sup> 6 App. Div. 2d at 568-69, 180 N.Y.S.2d at 25-26. Valente, J., dissented: "the statutory machinery for the enforcement of arbitration awards contemplates the exercise of a judicial function and not a ministerial one. No judgment should issue from the court which contravenes deeply ingrained principles and rules of equity jurisprudence regarding the specific performance of contracts for personal service." *Id.* at 572, 180 N.Y.S.2d at 29.

<sup>66</sup> 6 N.Y.2d at 163, 160 N.E.2d at 79, 188 N.Y.S.2d at 542.

<sup>67</sup> For an example of a court's refusal to enforce a remedy which it did find judicially intolerable, see *In the Matter of Publishers' Ass'n*, 280 App. Div. 500, 114 N.Y.S.2d 401 (1952).

the directors "may remove [an officer] at pleasure."<sup>68</sup> The appellate division was the only court to mention the section, and it merely asserted that the relation of the arbitration provisions to the statute was like that of fixed-term contracts of employment generally—neither offended the legislative language.<sup>69</sup> The assertion cannot stand: while in the damage cases the indirect conflict may be resolved by allowing both removal without cause and damages for such removal,<sup>70</sup> a direct clash with the statutory provision is unavoidable where an arbitration agreement sanctions specific performance. Such an award nullifies the power granted by section 60, which gives legislative force to the policy argument of protecting the corporation against itself. This provision and similar statutes<sup>71</sup> mean little if they do not protect the freedom of directors to act at all times in the manner which they believe will further the best interests of the corporation. This statutory policy of independent exercise of judgment by the board or its successors should not be negated by an agreement to arbitrate, as it was in *Staklinski*.<sup>72</sup>

#### AGREEMENTS WITH THE SHAREHOLDERS

A person negotiating for an executive position might prefer for a number of reasons to contract directly with the shareholders rather than with the corporation through its board of directors.<sup>73</sup> The contract might provide that the officer is to serve concurrently as a director;<sup>74</sup> in such a case, the directors would generally be unable to bind the corporation to the retention of a fellow director.<sup>75</sup> Or the prospective officer may believe—

<sup>68</sup> N.Y. STOCK CORP. LAWS § 60.

<sup>69</sup> 6 App. Div. 2d at 568, 180 N.Y.S.2d at 25.

<sup>70</sup> See notes 34-42 *supra* and accompanying text.

<sup>71</sup> For the states having statutory provisions substantially identical to § 60, see note 28 *supra*. This argument would also appear to be available in connection with statutes vesting the power to manage the corporation in the board of directors. See note 20 *supra*.

<sup>72</sup> Although this reasoning does not appear to fall within any of the exclusive grounds for vacation or modification of awards set out in N.Y. CIV. PRAC. ACT §§ 1462, 1462a, the New York courts, in the exercise of their equitable powers, see *In the Matter of Lipschutz*, 304 N.Y. 58, 63-64, 106 N.E.2d 8 (1952), have vacated or corrected awards on other grounds. See *In the Matter of Publishers' Ass'n*, 280 App. Div. 500, 114 N.Y.S.2d 401 (1952). Support for vacation of the award may be found in *Western Union Tel. Co. v. American Communications Ass'n, CIO*, 299 N.Y. 177, 86 N.E.2d 162 (1949) (alternative holding) (arbitration contract provision as construed below violated penal statute; vacation of award affirmed).

<sup>73</sup> See generally Meck, *supra* note 53, at 1080-82. The majority stockholder agreement is not merely an alternative; it may be supplementary to a contract with the corporation, thus giving the officer "two strings to his bow." *Id.* at 1082.

<sup>74</sup> *E.g.*, *Tremsky v. Green*, 106 N.Y.S.2d 572 (Sup. Ct. 1951). Such a provision is much more likely to be found in a contract involving a closely held corporation.

<sup>75</sup> Directors are generally elected by the stockholders. See, *e.g.*, N.Y. STOCK CORP. LAW § 55; 2 FLETCHER, CYCLOPEDIA PRIVATE CORPORATIONS § 285 (rev. ed. 1954); HORNSTEIN, CORPORATION LAW AND PRACTICE § 351 (1959). In a converse context, while cases will be found holding that the board of directors may remove fellow directors, see *Fells v. Katz*, 256 N.Y. 67, 175 N.E. 516 (1931), the weight of authority is against the proposition. See *Stott v. Realty Co.*, 246 Mich. 267, 224 N.W. 623 (1929). See also HORNSTEIN, *op. cit. supra* § 389, at 521.

perhaps with justification—that the shareholders will be more concerned over possible personal liability than will be the corporation over corporate liability. Or having bargained with the controlling shareholder, the officer may find a contract with that person to be the most natural culmination of the negotiations.<sup>76</sup> Although there is no reason other than practicability why such a contract could not be executed with a public corporation, shareholder-officer contracts will normally be found where the company involved is closely held.<sup>77</sup>

### Damages

As a general rule, it is held today that where all of the shareholders are parties to a contract to employ a person as an executive officer, the contract will give rise to an action for damages for its breach if the officer is removed without cause<sup>78</sup> before the natural termination of the contract.<sup>79</sup> But where less than all of the shareholders are parties, the agreements are usually invalidated.<sup>80</sup> This distinction most often rests upon a rationale seldom articulated in cases involving contracts with the corporation:<sup>81</sup> that the interests of noncontracting parties must be protected.

Thus, in 1899 in the only removal-of-officer case<sup>82</sup> to reach the United States Supreme Court, the Court held unenforceable a contract wherein defendant, the holder of five-sixths of a corporation's stock, agreed to use his influence as corporate president and controlling stockholder to retain

<sup>76</sup> See, e.g., *Jones v. Williams*, 139 Mo. 1, 39 S.W. 486 (1897), involving a contract with Joseph Pulitzer, whose iron hand had such control of the *St. Louis Post-Dispatch* as to be, in reality, the corporation.

<sup>77</sup> See *West v. Camden*, 135 U.S. 507 (1889); *Odman v. Oleson*, 319 Mass. 24, 64 N.E.2d 439 (1946); *Hayden v. Beane*, 293 Mass. 347, 199 N.E. 755 (1936); *Scripps v. Sweeney*, 160 Mich. 148, 125 N.W. 72 (1910); *Jones v. Williams*, 139 Mo. 1, 39 S.W. 486 (1897); *In the Matter of Burkin*, 1 N.Y.2d 570, 136 N.E.2d 862, 154 N.Y.S.2d 898 (1956); *Clark v. Dodge*, 269 N.Y. 410, 199 N.E. 641 (1936); *McQuade v. Stoneham*, 263 N.Y. 323, 189 N.E. 234 (1934); *Fells v. Katz*, 256 N.Y. 67, 175 N.E. 516 (1931); *Rochester v. Bergen*, 265 App. Div. 547, 39 N.Y.S.2d 840 (1943); *Heller v. Clark Merchandisers, Inc.*, 9 Misc. 2d 106, 154 N.Y.S.2d 150 (Sup. Ct. 1955); *Dubbs v. Kramer*, 302 Pa. 455, 153 Atl. 733 (1931); *Baran v. Baran*, 59 Pa. D. & C. 556 (C.P. 1947); *Roberts v. San Jacinto Shipbuilders*, 198 S.W.2d 488 (Tex. Civ. App. 1947).

<sup>78</sup> What has been said concerning removal *with* cause, see notes 2-3 *supra* and accompanying text, is equally true when the contract in question is made with the shareholders: removal with cause does not give rise to contract liability. See, e.g., *Fells v. Katz*, 256 N.Y. 67, 72-73, 175 N.E. 516, 517 (1931); *Tremsky v. Green*, 106 N.Y.S.2d 572 (Sup. Ct. 1951).

<sup>79</sup> E.g., *Kantzler v. Bensinger*, 214 Ill. 589, 73 N.E. 874 (1905); *Hayden v. Beane*, 293 Mass. 347, 199 N.E. 755 (1936); cf. *Clark v. Dodge*, 269 N.Y. 410, 199 N.E. 641 (1936).

<sup>80</sup> E.g., *Odman v. Oleson*, 319 Mass. 24, 64 N.E.2d 439 (1946). *Contra*, *Lockley v. Robie*, 301 N.Y. 371, 93 N.E.2d 895 (1950).

<sup>81</sup> See text following note 13 *supra* for the usual reasoning behind invalidation. But note that the possible-injury rationale is in fact the basis for failure to enforce officer-corporation contracts. There, it is argued, public policy compels the corporation, by its charter the creature of the state, to conform to the rules of its creator, one of which vests management in the board of directors or, more specifically, gives the directors power to remove officers at will. And the legislative aim in placing this power of management in the directors—a body held to the standards of fiduciaries—is to protect shareholders, creditors, and perhaps even consumers (for example, depositors in banks). See *Meck*, *supra* note 53, at 1085-86.

<sup>82</sup> *West v. Camden*, 135 U.S. 507 (1889).

plaintiff in the office of vice president and general manager. A unanimous Court found that "the agreement alleged to have been made was one on the part of the defendant whereby he might be required to act contrary to the duty which, as an officer of the . . . [corporation], he owed to that company and to the stockholders other than the plaintiff."<sup>83</sup> New York preferred to invalidate such contracts on grounds reminiscent of the early cases dealing with agreements with corporations:<sup>84</sup> that they stifled the directors' managerial power. In *McQuade v. Stoneham*,<sup>85</sup> plaintiff sued for damages for breach of a contract with defendant, majority shareholder in and a director of the New York Giants, whereby plaintiff became treasurer of the corporation and defendant promised his best efforts to retain plaintiff in that capacity. McQuade was removed without cause; the court of appeals reversed an award of damages, stating that "directors may not by agreements entered into as stockholders abrogate their independent judgment [in electing officers]."<sup>86</sup> More recently the Massachusetts Supreme Judicial Court denied enforcement of a contract entered into by all but one of the corporation's shareholders.<sup>87</sup> The contract provided that plaintiff was to be employed as clerk, vice president, and assistant treasurer as long as the parties were affiliated with the company. The court held that inasmuch as the one nonparticipating stockholder might be injured by it, the contract was void as against public policy.<sup>88</sup>

Reversing the reasoning used to strike down contracts with majority shareholders on the basis of potential injury to noncontracting parties, the New York Court of Appeals in *Clark v. Dodge*<sup>89</sup> upheld a contract entered into by *all* of the stockholders. Although the court paid its respects to the *McQuade* rule against limitation of the directors' power by stating that "there was no attempt to sterilize the board of directors,"<sup>90</sup> its emphasis was placed on the lack of injury to other interests: "Possible harm to *bona fide* purchasers of stock or to creditors or to stockholding minorities have more substance [than policy arguments]; but such harms are absent in many instances. If the enforcement of a particular contract damages nobody—not even, in any perceptible degree, the public—one sees no reason for holding it illegal . . . ."<sup>91</sup>

In the same year, 1936, Massachusetts held that a complaint alleging breach of an employment contract entered into by all of the shareholders

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<sup>83</sup> *Id.* at 520. (Emphasis added.)

<sup>84</sup> See notes 13 and 81 *supra* and accompanying text.

<sup>85</sup> 263 N.Y. 323, 189 N.E. 234 (1934).

<sup>86</sup> *Id.* at 328-29, 189 N.E. at 236.

<sup>87</sup> *Odman v. Oleson*, 319 Mass. 24, 64 N.E.2d 439 (1946).

<sup>88</sup> *Id.* at 25, 64 N.E.2d at 440.

<sup>89</sup> 269 N.Y. 410, 199 N.E. 641 (1936). Plaintiff and defendant were the corporation's only stockholders, holding 25% and 75% respectively.

<sup>90</sup> *Id.* at 415, 199 N.E. at 643. Earlier in its opinion, the court noted that it was admitted that the contract impinged the board's power slightly. *Id.* at 417, 199 N.E. at 642.

<sup>91</sup> *Id.* at 415, 199 N.E. at 642.

stated a cause of action.<sup>92</sup> In return for plaintiff's agreement to serve as general manager for at least seven years, the defendant shareholders were to transfer twenty-four shares to him, to elect plaintiff and any additional person selected by him to the board of directors, to vote to insure a board favorable to plaintiff, and not to sell any shares without first offering them to plaintiff. Despite the obvious limitations the agreement would place on the board of directors' power to manage the corporation, the court rejected the public policy attack<sup>93</sup> and stated that the contract was apparently a good faith agreement, entered into for the purpose of *benefit* to the corporation and all of the stockholders.<sup>94</sup>

In a close corporation, it is almost certain that the shareholders will also be directors or at least have personal control over those who are.<sup>95</sup> Thus, when all of the shareholders are signatories to an executive employment agreement, it is difficult to argue that the directors' discretion is unreasonably hampered by the contract. It is even more difficult to contend that the shareholders should be protected from such a contract—they have by their action disqualified themselves from any protection the court might extend to unrepresented interests. But where less than all of the shareholders sign, it is appropriate that the court scrutinize the contract and inquire as to the possibility of harm to noncontracting stockholders; this inquiry is especially warranted in the usual case of the closely held corporation.

Looking only at the direct harm to which the obligations of the contract might subject the corporation, such harm, if any, will be found in the excessive size of the salary offered or control given to the individual; this type of injury can be effectively controlled, however, by requiring good faith and reasonableness<sup>96</sup> at the time the majority shareholders enter into the agreement. The contract itself need not necessarily directly conflict with the removal and managerial powers of the director-shareholders, for the duties imposed on the corporation may not "sterilize the directorate."<sup>97</sup>

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<sup>92</sup> *Hayden v. Beane*, 293 Mass. 347, 199 N.E. 755 (1936). *Accord*, *Kantzler v. Bensinger*, 214 Ill. 589, 73 N.E. 874 (1905); *Cohen v. Wacht*, 124 N.Y.S.2d 207 (Sup. Ct.), *aff'd per curiam*, 282 App. Div. 1054, 126 N.Y.S.2d 910 (1953); *cf.* *Martocci v. Martocci*, 2 Misc. 2d 330, 42 N.Y.S.2d 222 (Sup. Ct.), *aff'd per curiam*, 266 App. Div. 840, 43 N.Y.S.2d 516 (1943).

<sup>93</sup> *But cf.* *Manson v. Curtis*, 223 N.Y. 313, 119 N.E. 559 (1918).

<sup>94</sup> 293 Mass. at 351, 199 N.E. at 756-57. *But see* *Roberts v. San Jacinto Shipbuilders*, 198 S.W.2d 488 (Tex. Civ. App. 1947), where the court disallowed recovery of damages for breach of contract in which defendant, who was director and president, and his family "owned or controlled all or practically all of the capital stock." *Id.* at 489. It was held that a contract which binds a director to elect an officer to a year's employment is void as against public policy because a corporation is entitled to a director's vote and judgment at all directors' meetings, uninfluenced by any prior commitments or agreements. *Id.* at 491.

<sup>95</sup> *Chayes, Madame Wagner and the Close Corporation*, 73 HARV. L. REV. 1532, 1533-34 (1960); *Meck, supra* note 53, at 1082-84.

<sup>96</sup> See notes 43-53 *supra* and accompanying text.

<sup>97</sup> See *Clark v. Dodge*, 269 N.Y. 410, 417, 199 N.E. 641, 643 (1936) (stating that a contract with all the shareholders did not sterilize the directors); *Fells v. Katz*, 256 N.Y. 67, 72, 175 N.E. 516, 517 (1931); *Martocci v. Martocci*, 2 Misc. 2d 330,



But more serious questions arise when the indirect effect of the agreement upon the corporation is considered. Inasmuch as liability upon breach is not that of the corporation but rather that of the contracting stockholders, the director-shareholders (or the directors controlled by the majority shareholders) may be reluctant to risk personal liability, even though the corporate interest might call for the officer's removal. But granting the possibility of this failure to act in the best interests of the corporation and even acknowledging the deleterious effects upon minority shareholder interests which may stem therefrom, the question remains whether these effects are serious enough to require that the removed officer be deprived of any remedy whatsoever by a judicial declaration of unenforceability of his employment contract. The discharged officer's injury is immediate loss of his job, whereas the derogatory effect upon minority shareholders is indirect, somewhat diffused, and difficult to ascertain or measure. So long as the officer's conduct does not rise to the level at which he might be discharged for cause, it is doubtful that the corporate damage will be substantial. Nor is the corporation put in a position of having no choice of action, as it is when arbitration awards granting specific performance are enforced; the statutory power of removal is not infringed. And underlying the entire theoretical structure on which denial of damages is based is a possibly fallacious assumption: it cannot be concluded as a matter of actual practice that the majority shareholder-directors will generally act against the corporate interest, for their personal interest substantially coincides with that of the company in a close corporation.

The issue thus resolves itself to whether prevention of the tangential and possible injury to minority stockholders should be favored over the avoidance of the immediate and serious consequences which fall to the officer removed without cause. The considerations discussed above suggest the granting of damages for breach of reasonable employment contracts with stockholders, whether the agreement be with the entire group or with the majority only.<sup>98</sup>

### *Specific Performance*

In the classic New York case of *Fells v. Katz*,<sup>99</sup> plaintiff, having contracted with five shareholders<sup>100</sup> of a corporation to serve as president for ten years, sued to compel reinstatement after having been removed by the

333, 42 N.Y.S.2d 222, 225 (Sup. Ct.), *aff'd per curiam*, 266 App. Div. 840, 43 N.Y.S.2d 516 (1943). The shibboleth originated and was aptly used to describe the effect of the contract in *Manson v. Curtis*, 223 N.Y. 313, 323, 119 N.E. 559, 562 (1918).

<sup>98</sup> Although the New York Court of Appeals apparently viewed majority shareholder employment contracts as valid in themselves in 1918, *Manson v. Curtis*, 223 N.Y. 313, 319-20, 119 N.E. 559, 561 (1918) (dictum), this view was negated in *McQuade v. Stoneham*, 263 N.Y. 323, 189 N.E. 234 (1934). However, Judge Lehman's concurrence in *McQuade*, *id.* at 333, 189 N.E. at 238, kept the thought alive, and a divided court of appeals has recently restored the contract to an enforceable status, unfortunately without discussion of the problems or of the contrary authorities. *Lockley v. Robie*, 301 N.Y. 371, 93 N.E.2d 895, *modifying* 276 App. Div. 291, 94 N.Y.S.2d 335 (1950) (specific performance granted).

<sup>99</sup> 256 N.Y. 67, 175 N.E. 516 (1931).

<sup>100</sup> All five shareholders were also directors.

directors. The supreme court dismissed the bill and the appellate division affirmed. The court of appeals, citing the statutory provision vesting management of the corporate affairs in the directors,<sup>101</sup> also affirmed:

The courts will not regulate . . . [the directors'] conduct in the reasonable exercise and performance of their duty, even though they may by such conduct render the corporation liable to actions for damages for unlawful discharge. An agreement among stockholders whereby the directors are bereft of their power to discharge an unfaithful employee of the corporation is illegal as against public policy.<sup>102</sup>

While there was sufficient evidence to support a finding that removal was for "cause,"<sup>103</sup> and although the opinion speaks of the power to remove "unfaithful" employees, the court's unwillingness to interfere, "even though . . . [the directors] may by such conduct render the corporation liable to actions for damages," indicates hesitancy specifically to enforce the contract even in the absence of cause. In 1943, in a case<sup>104</sup> not involving any question of removal for cause, the New York Appellate Division denied specific performance of a contract between the president and holders of most, though not all, of the stock of a close corporation. The court observed that "the directors of a corporation may not thus fetter in advance their discretion as to the selection and maintenance in office of the officers of a corporation,"<sup>105</sup> but what seemed in fact crucial to the decision was that plaintiff failed to establish his contention that all of the stockholders had consented to his long term of office.<sup>106</sup> On the other hand, where all shareholders have entered into the contract, the courts have generally been willing to grant specific performance;<sup>107</sup> indeed, New York has recently extended this rule of enforcement to a case<sup>108</sup> in which the employment contract was agreed to by a majority of the stockholders only.

<sup>101</sup> N.Y. GEN. CORP. LAWS § 27.

<sup>102</sup> 256 N.Y. at 72, 175 N.E. at 517.

<sup>103</sup> Plaintiff was simultaneously organizing a business which potentially offered competition to the corporation from which he was removed.

<sup>104</sup> *Rochester v. Bergen*, 265 App. Div. 547, 39 N.Y.S.2d 840 (1943) (per curiam).

<sup>105</sup> *Id.* at 548, 39 N.Y.S.2d at 841.

<sup>106</sup> It is interesting to note that the court does not say that all shareholders did not sign but rather that all did not *consent*. The New York court had previously considered, at the pleading stage, a case in which all the shareholders had been parties to the contract. In *Clark v. Dodge*, 269 N.Y. 410, 199 N.E. 641 (1936), it affirmed a lower court order denying dismissal of a complaint in an action seeking specific enforcement. The action arose, not as a result of removal by the directors but rather, as is often the case, upon the failure of the shareholders to vote as agreed. See *Baran v. Baran*, 59 Pa. D. & C. 556 (C.P. 1947). For the subsequent course of litigation in *Clark*, see 28 N.Y.S.2d 442 (Sup. Ct. 1939), *aff'd mem.*, 261 App. Div. 1086, 28 N.Y.S.2d 464 (1941), *aff'd mem.*, 287 N.Y. 833, 41 N.E.2d 102 (1942) (specific performance denied; damages granted).

<sup>107</sup> *E.g.*, *Jones v. Williams*, 139 Mo. 1, 39 S.W. 486 (1897) (all stockholders *ratified*, not signed; specific performance allowed); *Harris v. Magrill*, 131 Misc. 380, 226 N.Y. Supp. 621 (Sup. Ct. 1928); *Heller v. Clark Merchandisers, Inc.*, 9 Misc. 2d 106, 108, 154 N.Y.S.2d 150, 153 (Sup. Ct. 1955) (dictum).

<sup>108</sup> *Lockley v. Robie*, 301 N.Y. 371, 93 N.E.2d 895 (1950). *Baran v. Baran*, 59 Pa. D. & C. 556 (C.P. 1947), may be in accord. The uncertainty is due to the fact that the opening sentence states that holders of 95% of the stock were involved, but the court later insists that all of the stockholders were parties.

Regardless of the number of shares held by the contract signatories, the reasons against the granting of specific enforcement of executive employment contracts with corporations<sup>109</sup> are equally valid when those agreements are consummated with the shareholders. The officer has—or should have—an adequate damage remedy in a suit for breach of the contract. Perhaps in the closely held corporation even more than the widely held corporation, an unhappy marriage in management can have dire results.<sup>110</sup>

#### THE LAW TODAY: SUMMATION AND EVALUATION

Although many factors—statutes, corporate charters and bylaws, parties to the contracts, terms of the contracts, and notions of public policy—will have an impact on executive removal cases as they come before the courts, it is possible to make the following summary of present-day treatment of contracts purporting to employ an executive officer for a fixed term:

(1) *Removal with cause*: The contract will not in any event give rise to liability where adequate cause for removal can be shown.

(2) *Reasonableness of the contract*: The court will examine the terms of the contract in the light of all the surrounding circumstances and will allow an action upon it only if it is reasonable and entered into in the good faith belief that it will serve the best interests of the corporation.

(3) *Statutes authorizing removal*: In the twenty-three jurisdictions which provide by statute that an officer may be removed whenever the best interests of the corporation will be served thereby, but that such removal shall be without prejudice to the officer's contract rights, a reasonable contract of employment will give rise to contract damages in the event the officer is removed without cause.

(4) *Other jurisdictions*: Even in the two jurisdictions which expressly provide by statute that officers may be removed at the pleasure of the directors, a contract of employment will be enforced in an action for its breach without cause, subject to the considerations set forth in paragraph

<sup>109</sup> See notes 54-72 *supra* and accompanying text.

<sup>110</sup> This condemnation includes specific enforcement by the *Staklinski* device of previous arbitration, which also negates the directors' statutory power to remove and manage. See notes 68-72 *supra* and accompanying text. It is worthy of note that a unanimity agreement, pursuant to N.Y. STOCK CORP. LAW § 9, in the contract may be effective in preventing removal by arbitration. The issue of whether an officer-director should be removed was held not arbitrable in *In the Matter of Burkin*, 1 N.Y.2d 570, 136 N.E.2d 862, 154 N.Y.S.2d 898 (1956); the justiciable, and hence arbitrable, issue could not be reached inasmuch as the prerequisite removal by shareholders or directors was foreclosed by the unanimity agreement. See *Katcher v. Ohsman*, 26 N.J. Super. 28, 97 A.2d 180 (Super. Ct. 1953). Otherwise, it appears that arbitration to determine the validity of a removal is available. In the *Matter of Landersman*, 280 App. Div. 963, 116 N.Y.S.2d 495 (1952); *Martocci v. Martocci*, 2 Misc. 2d 330, 42 N.Y.S.2d 222 (Sup. Ct.), *aff'd per curiam*, 266 App. Div. 840, 43 N.Y.S.2d 516 (1943).

(5) below. In the remaining jurisdictions, whose statutes are silent as to removal, a contract will be similarly enforced, again subject to paragraph (5). And in these "silent" jurisdictions, the presence of a legislative command that the business and affairs of a corporation shall be managed by its directors will not preclude recovery.

(5) *Corporate charters and bylaws*: Where the statutes are silent on the validity of employment contracts or on the matter of recovery of damages for breach thereof, but do empower employment or election of officers on such terms as are not prohibited by the charter or bylaws, an express withdrawal of or self-limitation upon the power to make officers' employment contracts will preclude liability for breach of unauthorized agreements.

(6) *Shareholder contracts*: Courts will award damages for breach of employment contracts involving all shareholders, but those in which only a majority of the stockholders participate are usually unenforceable.

(7) *Specific enforcement*: Subject to paragraph (8) below, a contract of employment made with the corporation will not be specifically enforced. The officer will be left to his remedy of damages. But where all—and possibly where only a majority—of the stockholders are participants, the contract may be specifically enforced, provided that it is reasonable and that the removal was attempted without cause.

(8) *Arbitration*: Where the contract provides that disputes arising therefrom will be submitted to arbitration, and the rules governing the arbitrators allow the award of specific performance, if the issue is justiciable, a court may order compliance with the arbitrators' award of the equitable remedy.

The law has taken great strides toward providing adequate protection for the corporate executive who is removed unjustifiably. But there still remain areas in which advances can be made, without hampering corporate freedom of action and within the relevant statutory framework. Aside from those cases involving charters or bylaws which expressly limit tenure or preclude term contracts, a reasonable contract of employment for a fixed term—whether with the corporation, all the stockholders, or a majority of the stockholders—should be enforceable in an action for breach by removal without cause. Where the corporate bylaws provide that directors have the power to amend bylaws, contract damages ought not to be denied on the ground that a bylaw limits tenure or prohibits contracts for fixed terms; rather, the contract should be treated as amending the bylaw.

In contrast to the sound bases for allowing damage actions, the growing tendency of the courts to grant or affirm an award of specific performance passes the limits of necessity and freezes one facet of corporate management in the past tense, regardless of the present state of mind of the directors. In so doing, the trend plays at cross purposes with those

statutes which purportedly grant removal and managerial powers to the board. A corporation should not be compelled to retain as one of its officers a person whose service to the corporation is no longer considered desirable, even though his conduct may not give rise to a valid removal for cause.

S. S.